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Valuing professional practices

Court sheds light on calculating goodwill

Recently, a California appellate court reviewed a trial court's valuation of the goodwill in a plastic surgeon's practice for a marital dissolution case. The opinion in *In re Marriage of Ackerman* may be important because it suggests courts' preferred approach for determining reasonable compensation when quantifying goodwill.

Terms of the prenup

The Ackermans married in 1991 and legally separated about 10 years later. The husband obtained his medical license in 1981 and his board certification in plastic and reconstructive surgery in 1987. At that time, he launched a sole proprietorship practice.

The wife signed a premarital agreement that recognized the practice was the husband's separate property. Under the agreement, any increase in the practice's value would be deemed community property subject to division upon marital dissolution.

Any legitimate method

Goodwill can make up a significant portion of a professional practice's value. It may be calculated by any legitimate method that measures present value by taking into account some past result — so long as the evidence legitimately establishes value.

The *Ackerman* trial court applied the "capitalization of excess earnings" method to value the practice's goodwill. This method hinges on a comparison of the earnings of the professional with that of an average-performing peer. The excess earnings are attributable to goodwill.

Courts may determine the annual salary of a typical salaried employee who has had experience commensurate with the spouse who is the sole practitioner. Alternatively, a court could apply the "similarly situated professional" standard, which bases reasonable compensation on the cost of "hiring a nonowner outsider to perform the same average amount that other people are normally compensated for performing similar services."



The experts speak

The appellate court explained that experts and trial courts can use professional compensation surveys as guidelines for assessing the reasonable compensation of a practitioner's peers. But to be relevant, the surveys must account for similarly situated professional practices and practitioners.

The wife's forensic accountant used a national compensation survey that broke down statistics by region, specialty and years in practice. Relying on the data for the Pacific region, which encompassed several Western states, he calculated reasonable compensation to be \$291,000 under the median compensation and \$355,000 under the 75th percentile.

The husband's expert based his opinion on data from the American Medical Association's *Physician Socioeconomic Statistics* surveys for the United States. He also conducted a personal survey of plastic surgeons in the Newport Beach area to show that the husband generated almost the average amount of revenue paid to the local surgeons. The expert determined reasonable compensation to be approximately \$515,000 — less than the \$551,000 average compensation paid to the local survey group.

The court's concerns

The trial court voiced concerns with the surveys submitted by both experts. It was troubled by the wife's expert's use of a national survey of Western states, pointing out that cosmetic surgery relies on discretionary income, and that the amount in Southern California "is remarkably different" from that of states neighboring. It faulted the husband's expert for relying on reasonable compensation for employees because it didn't believe that someone earning the husband's income would work for an employer and receive "a third of what he's actually making."

It observed that the husband "is a guy with peculiar talent, training and expertise that is making a rather substantial amount of money because, among other things ... he has a special reputation in the community and he's doing this, in large part, as a self-employed person." The court ultimately put the amount of reasonable annual compensation at \$544,000. It explained that it used the husband's expert's methodology as a "curbstone."

Building a goodwill calculation

The wife challenged the trial court's determination of reasonable compensation, but the appellate court held that substantial evidence supported the figure as reasonable compensation for a similarly situated professional. The court also confirmed that, in establishing goodwill value, a court can consider opinion evidence, as well as the:

- ✓ Situation of the business premises,
- ✓ Amount of patronage,
- ✓ Personality of the parties engaged in the business,

EVALUATING OWNER COMPENSATION

When valuing a business, appraisers sometimes add part of the owner's compensation to reported earnings to adjust for "above-market" compensation. They may conclude that a reasonable buyer could hire someone to fill the owner's shoes for less compensation than the current owner earns.

Several factors could indicate the owner's compensation exceeds what's reasonable. Valuers look beyond the written job description to determine whether the owner actually performs all of the listed duties. The owner also may perform additional, unlisted duties that warrant consideration, though lower-level functions that can be delegated generally are excluded from the reasonable compensation calculation. Location can influence reasonable compensation, too. Some locales offer a stronger pool of replacement candidates. The quality of life and cost of living also will affect required compensation.

Reasonable compensation is analyzed in the context of the relevant industry. Studying the industry uncovers similarly situated companies that valuers can use as points of comparison. Ideally, valuers can access compensation data for such companies in the same area, but they may use online studies of other businesses.

Finally, valuers examine characteristics of the subject business, including history, size, performance, and competitive strengths and weaknesses. Each can affect the business's ability to find, hire and retain qualified employees.

- ✓ Length of time the business has been established, and
- ✓ Prevalence of customers who consistently patronize the business.

The trial court considered evidence of the husband's actual business situation, talent, training, expertise and reputation. It also concluded that a plastic surgeon in Newport Beach would generate greater income than the national average.

Make it or break it

The *Ackerman* case highlights the need to retain qualified financial experts when dealing with reasonable compensation and goodwill. While it provides an excellent discussion of these issues, there's still much ambiguity among the states in these two areas. It's important to look first at the applicable statutes and case law in a particular case's jurisdiction. ✨

Restoration of backup tapes

Conquering an electronic evidence challenge

Issues related to electronic evidence are mounting in all types of litigation, as evidenced by the 2006 amendments to the Federal Rules of Civil Procedure. One area drawing increased attention is the restoration of backup tapes with electronic data. Restoration often spirals into an expensive, burdensome process. Qualified forensic experts, however, can bring considerable relief.

Plan of attack

The first step in restoring backup tapes is tracking them down. It's easy for backup tapes to fall through the cracks, so forensic experts need to determine which backups the company has and where they might be found.

Typically, the experts consult with the employees charged with producing and maintaining backup tapes. These employees can provide information about the existing inventory of backup tapes and the company's backup policy and procedures. In addition, the employees can note any undocumented

digressions from the policies and procedures, which may well have been innocent and necessitated by unexpected circumstances.

The company's backup policies should describe how often the backup tapes are generated, as well as its tape-recycling policy. This doesn't mean there aren't other sources of backup tapes, though. Frequently, experts locate backup tapes that were created outside of the policy — for example, as part of upgrades, emergency responses, or the restructuring of the company or its systems.

Forensic experts will require access to the software used to make backup tapes, too. The software may be able to produce reports on the tapes it has spit out. These reports may include detailed catalogs that list the files duplicated on various backup tapes.



EXPERT HELP: NOW MORE IMPORTANT THAN EVER

As electronic evidence gains traction in courts, it's more important than ever to retain qualified forensic experts. Forensic experts bring in-depth knowledge of the applicable laws, best practices and effective techniques.

Your expert can establish the proper scope of the search and plan accordingly, focusing on appropriate computer systems and precluding spoliation and sanctions. This focus saves money by eliminating superfluous work and allowing IT staff to concentrate on its primary responsibilities. The client need not suffer a ripple-effect drop in productivity because its IT staff is otherwise occupied.

An expert's contribution doesn't necessarily end when the required data is located. A forensic expert can help you uncover telltale patterns and pieces of evidence. He or she also may play an indispensable role by testifying on the evidence. A forensic expert can testify with credibility on issues related to preservation and analysis of electronic evidence and educate the trier of fact on pivotal points.

Potential hurdles

Forensic experts can run into difficulties if the software or hardware used to create backup tapes is obsolete or unavailable. If the company lacks the original hardware — or hardware that performs the same functions — it can be an insurmountable hurdle. Out-of-date software generally presents less of an issue, because experts usually can devise methods to gain access to the programs.

Companies also can muddy the waters when they fail to label their backup tapes clearly. Without at least a date that can be



matched to software reports, forensic experts must survey each tape individually. Mislabeled tapes cause similar delays or missteps.

Further, a misunderstanding of the terminology and backup process may result in inaccurate expectations about available data. Backup tapes capture only the data available at a specific point in time. A company that performs weekly backups is not necessarily capturing all of the data from the week between

tapes but rather the data that exists on the specific days the tapes are made. Therefore, information created and deleted within the week may not leave a trail or be reproducible.

Actions of individual employees affect which data is caught, as well. On the day a backup tape is made, one employee may hold a year's worth of e-mails in his Deleted folder; another employee might wipe clear her Deleted folder every day. The backup tape would hold a wealth of e-mails for the former employee and far fewer for the latter. Such discrepancies can affect how many tapes an expert must restore to obtain the targeted information.

Get ahead of the game

In light of these potential issues and the reality of court-imposed deadlines, forensic experts should be put on the trail as soon as possible. And you might want to consult with a forensic expert even in the absence of litigation — he or she can help your clients develop effective backup policies and procedures to minimize unnecessary hurdles down the line. ✧

IRS business valuation guidelines: Would your appraisal pass muster?

The latest IRS business valuation guidelines are intended to provide standards for the agency's personnel engaged in valuation work. In many ways, the guidelines mirror the standards established by appraisal organizations such as the American Society of Appraisers, but they also include new sections that address workpapers and the review of third-party valuations. This information could prove valuable if you're concerned about how the IRS values businesses or reviews outside valuation reports.

Getting to the value

The new guidelines provide a list of information necessary to develop a valuation conclusion.

This list includes the:

- ✓ Nature and history of the business,
- ✓ General economic outlook and industry-specific conditions,

- ✓ Book value of the stock or interest and the financial condition of the business,
- ✓ Company's earning capacity,
- ✓ Existence of goodwill and other intangible value,
- ✓ Sales of the stock or interest and the size of the block of stock to be valued, and
- ✓ Market price of stocks or interests of corporations or entities engaged in the same or similar line of business that are actively traded in a free and open market, either on an exchange or over the counter.

The guidelines advise IRS valuers to exercise professional judgment in selecting a valuation approach — asset-, market- or income-based — and a method within such approaches. Valuers should analyze historical financial statements, making adjustments where necessary to reflect appropriate



asset value, income, cash flows and benefit streams to achieve consistency with the selected methodologies. To determine appropriate discount or capitalization rates, valuers must consider all relevant factors, including the nature of the business, the risk involved and the stability of earnings.

Finally, as appropriate to the assignment, the guidelines indicate that valuers, in reaching a final value conclusion, should consider:

Marketability. This includes the nature of the business, business ownership interest or security; the effect of relevant contractual and legal restrictions; and the condition of the markets.

Control. This refers to the ability of the appraised interest to control the operation, sale or liquidation of the business.

Other levels of value considerations. This should be consistent with the standard of value, such as the effect of strategic or synergistic contributions to value.

Valuers also are encouraged to consider any other factors they deem appropriate to the appraisal.

According to the guidelines, IRS valuers' workpapers should document steps taken and techniques used. And they should provide evidence to support the facts and conclusions in the final valuation report. Valuers also must maintain detailed case activity records. Together with the workpapers, the records should justify the time spent on the work.

Reviewing outside valuations

When reviewing a third-party valuation, IRS valuers are instructed to form an opinion on the adequacy and appropriateness of that valuation and clearly disclose the scope of work of the review. Among other steps outlined in the guidelines, reviewing valuers should determine:

- ✓ The completeness of the outside valuation report,
- ✓ The apparent adequacy and relevance of the data and propriety of any adjustments to the data,
- ✓ The appropriateness of the valuation methods and techniques used,
- ✓ Whether the analyses, opinions and conclusions under review are appropriate and reasonable, and
- ✓ Whether the report effectively communicates the methodology and reasoning and identifies supporting documentation.

The guidelines advise IRS valuers to exercise professional judgment in selecting a valuation approach.

As you probably know, IRS valuers may disagree with the factual representations, underlying assumptions, methodology or conclusions of outside valuations. In such cases, they should develop reasons for any disagreement and conduct additional research and analyses necessary to arrive at an appropriate value. The IRS's primary objective is to determine whether a valuation report provides compelling support for the conclusion of value reached.

Make the most of the guidelines

These new guidelines can come in handy if you need to dispute an IRS valuation. You might, for example, argue that the valuator in question failed to abide by them. Or you could wield the guidelines to assess how an outside valuator's report will stand up to IRS scrutiny.

The guidelines are binding only for IRS agents. It's important, however, to know them so that you understand both IRS positions on valuation issues and what is expected of the experts you engage to perform valuations. ✧

HOW TO BOLSTER YOUR CLIENTS' PRENUPTIAL AGREEMENTS

These days, prenuptial agreements aren't just for Hollywood stars and Wall Street moguls. With divorce rates remaining high and blended families on the rise, more of your clients are likely taking a pragmatic approach to marriage. With the input of a CPA, prenuptial agreements can affirmatively define spouses' financial rights, duties and obligations. Properly drafted, they can reduce stress and disagreements for your clients — before, during and after a marriage.

PROFESSIONAL TEAMWORK

Attorneys and CPAs can best accomplish a client's prenuptial goals by collaborating closely. Several areas in particular call for a joint effort. Early on, you should ensure the parties make full disclosure of their respective assets and liabilities. These disclosures should cast a wide net — catching not only property and employment compensation, but also furniture, vehicles, jewelry and intellectual property rights.

CPAs can develop a schedule of the parties' debts. These might include mortgages, student loans, accounts payable, promissory notes, credit card obligations and contingency liabilities associated with litigation or similar circumstances.

Although language used in the agreement would seem to fall in your purview, CPAs, who have an in-depth understanding of the implications of financial language and terms like assets, liabilities, revenue, expenses, and income, can lend a hand. Precise financial language is essential to capturing the client's intent. CPAs also can offer valuable input on the proper selection of measures, such as absolute, book or fair market value, as well as when to use each measure.



Consulting with CPAs regarding income tax issues related to prenuptial agreements and divorce ensures that they take into account the latest developments in tax law and which assets and payments are taxable, to whom and at what rate. The proper classification of payments as, for example, spousal support or child support often is critical to producing the desired tax consequences.

LET NO MAN TEAR ASUNDER

A single inappropriate provision could void an entire prenuptial agreement, triggering an avalanche of trouble. With tax and trust laws regularly evolving, both attorneys and CPAs should review prenuptial agreements at least annually to ensure the agreements continue to accomplish the parties' goals. Even if a prenuptial agreement ultimately isn't upheld, it will provide strong evidence of the parties' intents.



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